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July 13, 1998

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

BY HAND DELIVERY

Magalie Salas, Secretary
Federal Communications Commission
1919 M Street, Room 222
Washington, D.C. 20554

Re: In the Matter of Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996, CC Docket No. 96-128

Dear Ms. Salas:

Please find enclosed for filing an original and four copies of the RBOC/GTE/SNET Payphone Coalition's Comments on Remand Issues in the above-captioned proceeding.

Please date-stamp and return the extra copy provided to the individual delivering this package.

Sincerely,

Michael K. Kellogg

Michael K. Kellogg

Enclosures

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BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of

Implementation of the Pay Telephone	)	
Reclassification and Compensation	)	CC Docket No. 96-128
Provisions of the	)	
Telecommunications Act of 1996	)	

COMMENTS ON REMAND ISSUES

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July 13, 1998

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EXECUTIVE SUMMARY

The D.C. Circuit did not criticize and certainly did not reject the Commission's avoided cost methodology for deriving a per-call compensation rate from the deregulated local coin price. Rather, the Court found the Commission's explanation for that methodology inadequate in two main respects. First, the Court believed that the Commission did not explain adequately why the local coin market provides an appropriate surrogate for the coinless market. Second, the Court held that the Commission failed to explain why it made sense to subtract costs from a market rate that is unrelated to costs.

In its forthcoming Order on Reconsideration, the Commission can and should correct all of these perceived deficiencies in its Second Report and Order. But the Commission should not change its market-based, deregulatory approach. Indeed, the Court itself has affirmed the premise underlying the Commission's basic approach to this rulemaking: the Commission may rely on market proxies, rather than questionable cost accounting figures, to set a reasonable default compensation rate for uncompensated coinless calls. Moreover, in its prior decision, the Court also upheld the Commission's judgment that the payphone market is sufficiently competitive to maintain the local coin rate at competitive levels. Once the Commission has offered a more detailed explanation of its avoided cost methodology, the Court can be expected to uphold the Commission's approach.

Accordingly, the RBOC/GTE/SNET Payphone Coalition's remand comments are focused on providing the explanation and economic support that the D.C. Circuit found wanting. We have included affidavits from three distinguished economists -- including one Noble Laureate -- explaining why the Commission's avoided cost methodology is both economically efficient and fair.

I. There can be no serious dispute that a market-based compensation rate is superior to a regulated rate based on some measure of the costs of providing payphone services. A cost-based rate would be administratively burdensome, imposing continuing regulatory obligations on an industry that has always been free of such red tape. Rate-of-return regulation is also notoriously inaccurate and creates perverse incentives. Most important, a market-based rate can account for differences in costs among different locations and for changing market conditions over time. A rate based on some measure of average costs will discourage deployment of phones with below-average call volumes or above-average costs. A market-based rate, by contrast, encourages the efficient, widespread provision of payphone services.

II. In the case of dial-around and subscriber 800 calls, regulatory barriers make it impossible for the market to set the price directly. The Commission therefore properly sought an appropriate market-based proxy for the coinless call market.

A. By choosing the local coin market, the Commission selected the most conservative starting point for its market-based analysis. IXCs routinely pay far more than $.35 for the opportunity to carry 0+ calls from payphones. Other market indicators of the value of payphone services also indicate that the $.35 rate is the most conservative possible starting point.

B. If the Commission starts with the local coin rate, it should adjust that rate upward in setting the per-call compensation rate to take demand conditions into account. The Coalition has explained that allocation of joint and common costs based on relative demand elasticities would mirror market results better than equal allocation of such costs. The demand elasticity information in the record indicates that the derived elasticity of demand for dial-around and subscriber 800 calls is significantly less than the elasticity of demand for coin calls. In a market free of regulatory barriers, therefore, the compensation rate on dial-around and subscriber 800 calls would likely be significantly higher than the local coin rate. The best available market evidence bears this out.

III. Although the Coalition believes that the best approach is to rely on 0+ rates or at least to adjust the local coin rate upward based on demand conditions, the Commission's decision to adopt a net avoided cost approach based on the local coin rate (while conservative) still results in a rate that is both economically efficient and "fair" within the meaning of the Act.

A. As three leading economists describe in detail in their attached declarations, avoided cost pricing is a valid regulatory technique for determining the price that the market would set for a product where the market cannot function directly because of regulatory constraints. Under an avoided cost approach, the market-determined price for one service is used as a starting point for deriving the regulated rate for another service. Costs unique to the service for which a market exists are subtracted from the market price; costs unique to the other service are added to the market price. The resulting rate thus ensures that the facility owner will earn the same economic return from each service.

In an effectively competitive market, the price of service reflects short-term variable costs plus some measure of fixed costs. By subtracting (or adding) costs associated only with a particular service, the avoided cost technique mirrors the result that would obtain in a competitive market, where a single facility is used to provide two services. In a competitive market, the facility will earn the same return from each service -- setting to one side, as the Commission has done, differences in relative elasticity of demand.

B. This avoided cost approach is "fair" in the sense that it requires all payphone users to make an equal contribution to the joint and common costs of the payphone. Those who benefit from the placement of the payphone should make an equal contribution to those costs.

The approach is also "fair" in that it ensures that the opportunity costs for each kind of call are the same.

IV. Economic analysis teaches that avoided cost pricing is appropriate where 1) there is a single facility used to provide more than one service; 2) at least one of the services is sold in a competitive market; and 3) the differential costs between the services is calculable. All these conditions are satisfied in the market for payphone services.

First, the same payphone is used to provide service to local callers, calling card callers, and callers to 800 subscribers.

Second, the local coin market is highly competitive by any measure. There are hundreds, even thousands, of participants in this market, and the largest providers of payphone services hold a relatively small percentage of the market nationwide. More important, entry into the payphone market is easy -- the Commission has properly concluded that there are no barriers to entry. Under these circumstances, no participant in the market can exercise market power.

Third, and finally, the differences in costs between coin calls and coinless calls can be calculated.

V. The various objections raised by carriers to the Commission's avoided cost approach are without merit.

A. It has been objected that the market for local coin calling is imperfect because premises owners have "locational monopolies," that is. the ability to charge higher prices in isolated locations where demand for payphone services may be high. This objection is empirically baseless and logically dubious. Moreover. the problem is not one that even theoretically affects the validity of the default rate during the current transition period, and the Commission has mechanisms in place for addressing the problem if it arises.

B. Carriers have expressed concern about the fact that payphones do not accept pennies, so that local coin service must be priced in five-cent increments. This concern is misplaced. Many markets have prices that are rounded off to the nearest dollar, 50-cents, or nickel. Rounding in this way does not mean that a market is not competitive, nor that participants in the market earn economic rent. It simply means that supply adjusts incrementally to these incremental changes in price. Moreover, no party has suggested why rounding to the nearest nickel would, on average, be upward rather than downward.

C. The purchaser of payphone services in the case of local coin calling is the caller, while the purchaser in the case of subscriber 800 calls is the 800-number subscriber. But this does not mean that the local coin market does not provide a valid proxy for the 800 subscriber market. To the contrary, the Commission's avoided cost methodology ensures that so long as the local coin rate is effectively competitive, the default rate too will reasonably reflect the cost of service. Moreover, the availability of call blocking means that 800 subscribers can make the choice whether to consume payphone services, or attempt to negotiate a better rate.

VI. The Coalition's Petition for Reconsideration demonstrated that the Commission's application of its avoided cost methodology suffers from significant flaws. Two of these are particularly important. First, the Commission erred in attributing coin mechanism costs to coin calls alone. Second, the Commission erred in attributing Flex ANI costs to all calls, rather than to coinless calls only. The Commission should not lose sight of these important issues on remand.

BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C.

In the Matter of

Implementation of the Pay Telephone	)
Reclassification and Compensation	) CC Docket No. 96-128
Provisions of the	)
Telecommunications Act of 1996	)

COMMENTS ON REMAND ISSUES

The RBOC/GTE/SNET Payphone Coalition (the "Coalition")[1] hereby comments on the issues identified in the Commission's June 19, 1998, Public Notice, DA 98-1198 ("Remand Notice").

INTRODUCTION

In MCI Telecommunications Corp. v. FCC, No. 97-1675 (D.C. Cir. May 15, 1998) ("Payphones II"), the D.C. Circuit upheld the fundamental premise underlying the Commission's approach to setting the per-call compensation rate for uncompensated payphone calls: "In principle, a market-based rate -- as opposed to a cost-based rate -- could satisfy the statutory fair compensation requirement." Slip op. at 6. At the same time, however, the Court held that the Commission had failed to explain adequately its decision to employ an avoided cost methodology for calculating a per-call compensation rate for coinless calls based on the local coin rate. See id. at 5 ("The Commission never explained why a market-based rate for coinless calls could be derived by subtracting costs from a rate charged for coin calls.").

[1]The RBOC/GTE/SNET Payphone Coalition includes Ameritech, the Bell Atlantic Telephone Companies, BellSouth Corporation, GTE Service Corporation, Pacific Bell, Nevada Bell, SNET, Southwestern Bell Telephone Company, and U S WEST.

The Court expressed two interrelated concerns about the Commission's approach. First, it questioned whether "the Commission is correct in assuming that the 'market rate' for coinless calls, from which costs are deducted, should be the same as the rate for coin calls." Id. The Court thus indicated that the Commission had failed to explain why it made sense to choose the market-determined local coin rate as a surrogate for the rate that a free market would set for coinless calls. Second, it noted that while the Commission's reasoning may have depended on the premise that the market for coin calls was competitive, and that rates and costs would therefore converge in that market, the Commission never "went through the steps of connecting this premise with its reasoning." Id. That is, to the extent that the Commission's methodology was intended to set a rate that would reasonably reflect costs, the Commission never explained how its methodology would accomplish this result. In particular, the Commission failed to "expressly claim that costs and rate do in fact converge in the coin call market." Id.

In its forthcoming Order on Reconsideration, the Commission should naturally respond clearly to all of the Court's concerns, but it need not and should not alter its basic methodology. Though the D.C. Circuit rejected the Commission's explanation of its avoided cost methodology, it pointedly declined to reject the methodology itself, despite the IXCs' importuning. Instead, it left the current per-call default rate in place, and remanded the case specifically to permit the Commission to improve its explanation of, and justification for, the avoided cost methodology. Id. at 6 ("[W]e conclude that the Commission did not adequately explain the action at issue here.").

The Commission can put the D.C. Circuit's concerns firmly to rest. The coin market is an appropriate surrogate for the coinless market because, in a competitive market, the price of a coin call will reflect the costs of a payphone, including joint and common costs. The Commission has already found that the market for payphone calls is competitive, and the D.C. Circuit has affirmed that finding. By adjusting the local coin rate for costs that are unique either to coin calls or to coinless calls, the Commission reasonably approximated the costs of a coinless call. Three leading economists, including a Nobel Prize winner, attest to the validity of the Commission's approach. In sum, the Commission's avoided cost approach is an appropriate response to the problem of setting a default rate for coinless calls.

DISCUSSION

I. A MARKET-BASED APPROACH IS SUPERIOR TO A COST-BASED APPROACH AND HAS BEEN APPROVED BY THE D.C. CIRCUIT

From the start of this payphone proceeding, the Commission has committed itself to "a new deregulatory structure for the payphone industry." First Report and Order,[2] 11 FCC Rcd at 20545, ¶ 6. In a competitive market, "the most appropriate way to ensure that PSPs receive fair compensation for each call is to let the market set the price for individual calls originated on payphones." Id. at 20567, ¶ 49. "It is only in cases where the market does not or cannot function properly that the Commission needs to take affirmative steps to ensure fair compensation." Id. Most prominently, the Commission determined that it was required to "provide for compensation for all access code calls, subscriber 800 and other toll-free number calls." Id. at 20568, ¶ 52.

Even here, however, the Commission has consistently opted for a market-based, over a cost-based, approach to per-call compensation. Id. at 20576-77, ¶ 68. See also Order on

[2] First Report and Order, Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996, 11 FCC Rcd 20541 (1996).

Recon.,[3] 11 FCC Rcd at 21268, ¶ 69. And, although the D.C. Circuit has found that the Commission has twice failed adequately to explain the exact market-based approach it has taken, the court of appeals has squarely affirmed the validity of a market-based approach to setting compensation for payphone calls. See Payphones II, slip op. at 6 ("[A] market-based rate -- as opposed to a cost-based rate -- could satisfy the statutory fair compensation requirement."); Illinois Pub. Telecomms. Ass'n v. FCC, 117 F.3d 555, 565 (D.C. Cir. 1997) ("Payphones I") ("A market-based approach is as much a compensation scheme as a rate-setting approach.").

Nor can there be any serious doubt about the soundness of the Commission's conclusion that a market-based rate is superior to a "bottoms-up," cost accounting approach to setting the per-call rate. A cost-based rate would have several disadvantages. First, the imposition of the regulatory burdens of a full-blown cost proceeding in an otherwise deregulated, competitive industry would be wasteful and contrary to the clear intent of Congress to create a "pro-competitive, de-regulatory national policy framework" in the 1996 Act. See Order on Recon., 11 FCC Rcd at 21266, ¶ 66 ("[I]t would be particularly burdensome to impose a TELRIC-like costing standard on independent [PSPs] who have not had previous experience with any costing systems.").

Second, cost-based regulation is notoriously inaccurate and contentious. Commenters in the payphone proceeding have purported to document costs ranging from 5.7 to over 40 cents per coinless call. Compare Second Report and Order,[4] 13 FCC Rcd at 1799, ¶ 49 with id. at 1810,

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[3]Order on Reconsideration, Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996, 11 FCC Rcd 21233 (1996).

[4]Second Report and Order, Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996, 13 FCC Rcd 1778 (1997).

¶ 69 n.181. See also Declaration of Professor Gary Becker ¶ 40 ("Becker Decl.") (attached hereto as Exhibit A). In addition, regulatory determination of relevant costs, from the ground up, entails controversies over the proper rate of return, the proper rate of compensation, the proper division of revenue between the PSP and the location provider, and so on. See Declaration of Alfred E. Kahn at 7 ("Kahn Decl.") (attached hereto as Exhibit B). The Commission was right to avoid such administrative nightmares.

Third, cost-based, rate-of-return type regulation can also create perverse incentives. Companies may be encouraged to increase costs, and face few incentives to increase efficiency, if the rates for their services are based on costs. See Declaration of Professor Jerry Hausman ¶ 13 ("Hausman Decl.") (attached hereto as Exhibit C). The D.C. Circuit itself cited the types of perverse incentives that cost-based rate regulation can create, when it suggested that PSPs might be induced to maintain uneconomical, high-cost payphones just to raise the average costs of such phones. See Payphones II, Transcript of Oral Argument at 35 (May 7, 1998). By setting a market-based rate, the Commission ensures that the industry will place phones where they are economical, and provides incentives for PSPs to pursue efficiencies. See First Report and Order, 11 FCC Rcd at 20570, ¶ 55 ("Competition over time will lead to the more efficient placement of payphones, improved payphone service, and lower prices.").

Fourth, a cost-based approach in practice will always lack the precision and flexibility of a market-based approach. Cost-based approaches must depend on some measure of average costs. A rate set by reference to such average cost measurements will undercompensate payphones that have above-average costs and/or below-average call volumes, even when the market would sustain such phones by setting a higher price for calls from that phone. See Becker

Decl. ¶¶ 38-39. A market-based rate can take account of such variations. For a cost-based approach to do so, it would have to determine the costs for each individual phone -- an impossibly burdensome task. Kahn Decl. at 8-9; Hausman Decl. ¶¶ 11-12. And a market-based rate can rely on the market's ability to adjust prices over time to account for changes in technology, and changing competitive conditions. See Becker Decl. ¶ 36 ("[I]f market forces gave rise to local call coin rates that differ by time of day or by geographic area, compensation on dial-around/800 calls would adjust automatically to preserve equal margins for various types of calls. This is a highly desirable mechanism assuming that changes in market conditions affect payphone access rates equally.") Again, for a regulator to make the same sort of adjustments by investigating cost data would be intrusive, expensive, and inaccurate -- if it is even conceptually possible.

Finally, a cost-based approach based on some measure of average costs[5] will unduly "limit[] a PSP's recovery of its costs" in higher-cost and lower-volume areas and thereby "lead to a reduction in payphones" -- a result that is flatly inconsistent with section 276's purpose of "'promot[ing] the widespread deployment of payphone services to the benefit [o]f the general public.'" Order on Recon., 11 FCC Rcd at 21267, ¶ 66.[6] See Becker Decl. ¶ 3 (cost-based

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[5]The Commission was right to focus on the "marginal" payphone in its analysis in the Second Report and Order, but the Commission's method was designed to calculate the marginal volume for a payphone with average costs. In the market, the true marginal payphone will be the one with both high costs and low call volumes. While it would not necessarily be prudent to set a default rate to preserve such a phone, the Commission's market-based rate -- by reflecting local coin rates of individual payphones (after the end of the transition period) -- will automatically reflect the costs of such payphones.

[6]The Commission, like any regulatory body, faces political pressure to keep rates as low as possible. See e.g., Petition for Reconsideration of the Consumer-Business Coalition for Fair Payphone-800 Fees (filed Dec. 1, 1997); see generally Kahn Decl. at 8. Reliance on market surrogates adds objectivity to the ultimate rate and removes politics from the equation to a great

methodologies proposed by IXCs "would yield levels of compensation below what would arise in a competitive market and, therefore would lead to an inefficient restriction of payphone services").

In short, though the IXCs continue to plead for a return to the cost-based regulation of the telecommunications businesses that others run, such a reactionary approach would be economically inefficient and contrary to the spirit of the 1996 Act and the congressional mandate for a "pro-competitive de-regulatory national policy framework" for the telecommunications industry. S. Conf. Rep. No. 104-230, at 3 (1996).

II. THE LOCAL COIN RATE IS THE MOST CONSERVATIVE STARTING POINT FOR A MARKET-BASED PER-CALL COMPENSATION RATE

The Commission determined that it could not rely on the market to set the rate for access code and subscriber 800 calls directly. Because TOCSIA "requires all payphones to unblock access to alternative OSPs through the use of access codes (including 800 access numbers)," PSPs are obliged to make their payphones available for use by IXCs and their subscribers. See First Report and Order, 11 FCC Rcd at 20567, ¶ 49. Absent regulatory intervention, IXCs would thus have no incentive to pay PSPs any compensation at all for access code calls. And that would plainly violate the requirements of section 276, which provides that PSPs be fairly compensated for each call made on their payphones.

Unable to rely on the market directly, the Commission decided to rely on a market surrogate to set a default rate, to be paid in the absence of a contract between the parties. Presented with two obvious market surrogates upon which to base the default rate, the

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extent, substituting the law of the market.

Commission relied exclusively on the more conservative: the market rate for local coin calls. Then, by declining to adjust the rate upward for demand factors, the Commission suppressed the per-call rate even further. Thus, the Commission's approach has been doubly conservative.

In its public notice, the Commission has inquired about "other market-based methodologies that could be used to establish a per-call compensation rate for coinless calls." Remand Notice at 2. Accordingly, the Coalition continues to advocate both the use of 0+ commissions as a more appropriate market surrogate for coinless call traffic and inverse-elasticity pricing.

A. The Local Coin Rate Is the Lowest Market Rate

The local coin rate is not the only market rate for payphone services; it is merely the lowest such rate. The Coalition has pointed out from the start of this proceeding that a closer surrogate for the coinless call market is the market for 0+ calls. Operator Service Providers (OSPs) freely negotiate with PSPs to receive 0+ traffic; the Coalition showed that, on average, AT&T pays between $.78 and $1.14 per commissioned call; Arthur Andersen estimated the market average for such commissions at $.90 to $1.33. See RBOC/GTE/SNET Payphone Coalition Comments on Remand at 25 (filed Aug. 26, 1997) ("Coalition Remand Comments").

The 0+ commission rate is an excellent surrogate for the dial-around market; indeed, there is simply no better measure of the amount OSPs are willing to pay for such calls in a free and open market. The Commission declined to rely on it because "use of 0+ commission data would tend to overcompensate PSPs because these commissions may include compensation for factors other than the use of the payphone, such as a PSP's promotion of the OSP through placards on the payphone." First Report and Order, 11 FCC Rcd at 20577, ¶ 69. But, even if a modest adjustment were required to account for such factors, there can be no serious doubt that in a free market, where PSPs would be free to deny IXCs the use of payphones, IXCs would pay something quite close to the 0+ commission rate to have the use of payphones for highly lucrative dial-around traffic.

It may be true that IXCs gain less revenue from 800 calls, but there is no reason to believe that IXCs would be unwilling to pay a similar percentage commission to provide payphone service to their 800 subscribers. The Coalition showed that using the market commission rate, based on average IXC revenues from subscriber 800 calls, a blended per-call commission rate for all coinless calls would be between \$.39 to \$.63 per call. See Coalition Remand Comments at 26. Professor Hausman has explained that the Commission's failure to take account of these higher market rates for payphone services was unduly conservative. See Hausman Decl. ¶ 15.

Rather than rely on 0+ commission rates, the Commission chose to rely on the local coin rate in deregulated markets; that rate was \$.35 in the majority of the States with deregulated rates.[7] Current data show that in 43 of the 48 contiguous United States, the prevailing local coin rate is \$.35.[8] See Declaration of Carl Gepert at 2 ("Andersen Decl.") (attached hereto as Exhibit D). Moreover, in some States, the \$.35 rate covers only an initial period; longer local calls

[7]In the First Report and Order, the Commission found that in four of five States with deregulated local coin markets, the prevailing rate for a local call was \$.35. 11 FCC Rcd at 20570, ¶ 56. In the Second Report and Order, the Commission noted that the prevailing rate was \$.35 in five of seven States with deregulated local rates.

[8]The exceptions are Connecticut, Montana, New York, Rhode Island, and South Dakota. In Hawaii, as well, the prevailing rate is \$.25. In some of these States, these rates may reflect de facto regulatory barriers to free-market pricing (in particular, pressure exerted on pricing decisions by State commissions) and, thus, may not be truly competitive rates.

require additional coin deposits.[9] Thus, $.35 is itself a conservative estimate of the prevailing local coin rate.

Other rates for the use of a payphone -- both regulated and unregulated -- similarly exceed the local coin rate. For example, 0- transfer rates -- set in Commission tariffs -- have been shown to average in excess of $.40 per completed call. See Comments of the RBOC Payphone Coalition at 11-12 n.12 (filed July 1, 1996); APCC Comments on Remand at 9 (filed Aug. 27, 1997). And 1+ sent-paid charges exceed basic long distance charges by an average of $1.45 per call. See APCC Comments on Remand at 9-10. Thus every measure of the value of payphone access available to the Commission actually exceeded -- often by several times -- the competitive local coin rate. For this reason, the choice of the local coin rate as a starting point for the Commission's market-based analysis was extremely conservative.

B. The Local Coin Rate Should At Least Be Adjusted To Take Demand Conditions Into Account

Even if the Commission uses the local coin rate as the appropriate starting point for its analysis, it should adjust that rate to take demand conditions into account. From the start of the proceedings following the Payphones I remand, the Coalition has explained that the Commission would best reflect market results by using a methodology that would allocate fixed costs based on the relative elasticities of demand for payphone services. The D.C. Circuit has recognized

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[9]This is true, for example, in New Jersey (where $.35 covers a four-minute call; each additional four-minute period costs $.10), New Hampshire, and Vermont. In Connecticut, the initial $.25 deposit covers a three-minute call; each additional five-minute period costs an additional $.25. Likewise, in New York and Rhode Island, there is an additional charge after an initial period for local calls. Thus a flat $.25 charge is currently effective in only two of the 48 contiguous United States, containing a combined total of less than one percent of the country's population.

that such a methodology "theoretically ensures the most economically efficient use of services." Asiana Airlines v. FAA, 134 F.3d 393, 402 (D.C. Cir. 1998). If the Commission employed such a methodology, it would set a per-call rate well in excess of the $.35 local coin rate. Again, the best market evidence — the rates that IXCs now voluntarily pay to PSPs for 0+ traffic — confirms that the per-call compensation rate should exceed the local coin rate.

The Coalition has fully explained the justification for taking demand conditions into account in setting the coinless rate in its Comments (filed Aug. 26, 1997) and its Petition for Reconsideration (filed Dec. 1, 1997). The Commission has acknowledged that a firm in an effectively competitive market would take account of differences in demand elasticities. See Second Report and Order, 13 FCC Rcd at 1807-08, ¶ 64. Specifically, in the case of joint products, a producer will recover a larger proportion of joint and common costs on the sale of products for which there is a lower elasticity of demand, and a smaller proportion from those with higher elasticities. See Coalition Remand Comments at 20-24.

The Coalition has presented evidence that the percentage fall in demand for local coin calling as a result of a percentage increase in the price of a local call is greater than the percentage fall in demand for dial-around and subscriber 800 calls as a result of a percentage increase in the per-call compensation rate: in other words, elasticity of demand for local coin calls is higher. See id.; Hausman Decl. ¶¶ 19-29. A competitive firm would therefore allocate more of its joint and common costs to the per-call compensation charge than to the local coin rate; per-call compensation should therefore be higher than the local coin rate -- by at least $.07.

While the Commission expressed a lack of confidence in the Coalition's demand data, and while AT&T's expert economist attempted to poke holes in the analysis, none of the objections to the Coalition's analysis should dissuade the Commission from adopting the "most economically efficient" pricing methodology. See Asiana Airlines, 134 F.3d at 402. The Coalition has provided accurate elasticity data. Under any plausible account of demand conditions, it is clear that PSPs would allocate a greater proportion of joint and common costs to per-call compensation than to the local coin rate. See Coalition Petition for Reconsideration at 4-8. Moreover, empirical market evidence confirms this analysis. As described above, the current market compensation rate that IXCs voluntarily pay to receive long distance calls from PSPs is $1.00 or more per call. By providing IXCs these calls at less than the local coin rate, the Commission provides the IXCs with an unjustified windfall -- payphone services at a rate far below the rate that IXCs would pay in a competitive market free of regulatory barriers.

III. AN AVOIDED COST METHODOLOGY IS BOTH ECONOMICALLY EFFICIENT AND FAIR

Although we believe that the best market-based approaches are to rely on 0+ rates or to adjust the local coin rate upward based on demand conditions, the Commission's decision to adopt a net avoided cost approach based on the local coin rate can still result in a rate that is both economically efficient and fair.

The D.C. Circuit was concerned that the Commission's avoided cost approach entailed "subtracting apples from oranges," that is, a measure of costs from a rate that is unrelated to costs. Payphones II, slip op. at 5. The Court was also concerned that, given that local coin calls and dial-around and 800 calls are made in different markets, the Commission had failed to explain why "the 'market rate' for coinless calls, from which costs are deducted, should be the same as the rate for coin calls." Id.

The Commission can and should set the Court's concerns to rest. As three eminent economists -- including a Nobel Prize winner -- attest, both steps in the Commission's analysis are valid. First, the local coin rate is an appropriate surrogate for dial-around and 800 calls because both use the same payphone. Even though, from a demand perspective, the two types of calls may be in different markets, from a supply perspective, they are in the same market because they use the same instrument. Second, since the local coin rate reflects costs, applying a net avoided cost analysis to the local coin rate will accurately reflect the costs of dial-around and 800 calls. Because market forces drive prices towards cost, the market-based local coin rate will accurately reflect the costs of using a payphone. And -- since the same payphone is used for both local and dial-around and 800 calls -- the local coin rate, adjusted for differences in cost, will accurately reflect the cost of dial-around and 800 calls.

In short, avoided cost pricing is a valid regulatory technique for determining the price that the market would set for a product where the market cannot function directly because of regulatory barriers.[10] The avoided cost price is efficient because it results in the same rate that would be set in a competitive market. And because the technique ensures that the producer will recover the same proportion of joint and common costs with each service, the avoided cost price is also "fair" within the meaning of the statute.

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[10]Indeed, Congress itself used something much like an avoided cost pricing technique to establish pricing rules for services made available for resale. See 47 U.S.C. § 252(d)(3) (providing that state commissions must set wholesale rates "on the basis of retail rates charged to subscribers . . . excluding the portion thereof attributable to . . . costs that will be avoided by the [LEC]").

A. Avoided Cost Pricing Is Efficient

It is a fundamental principle of economics -- recognized by the Commission and the Court alike -- that, in a competitive market, price reflects suppliers' costs. See First Report and Order, 11 FCC Rcd at 20577, ¶ 70 ("[D]eregulated local coin rates are the best available surrogates for payphone costs"); Payphones II, slip op. at 5 (noting that "in a competitive market . . . costs and rate converge"); see also Tejas Power Corp. v. FERC, 908 F.2d 998, 1004 (D.C. Cir. 1990) ("In a competitive market, . . . it is rational to assume that the terms of . . . voluntary exchange are reasonable, and specifically to infer that price is close to marginal cost, such that the seller makes only a normal return on its investment.").

Competition need not be perfect for this principle to hold. In theory, perfect competition will drive prices toward marginal cost. But perfect competition exists only in economic textbooks. In reality, we have imperfectly (but still effectively) competitive markets, in which price will reflect two components: the incremental or marginal cost of providing the service, plus a mark-up to cover fixed costs. See Hausman Decl. ¶ 6 & n.1; Kahn Decl. at 3-5. Where a single facility is used to provide more than one service -- as in the case of a payphone -- the price of each service will reflect its own incremental or marginal cost plus some portion of the common costs of the facility. See Becker Decl. ¶¶ 19, 26. Put another way, the price of each product will reflect a margin over incremental costs; that margin is necessary to permit the producer to recover its fixed costs. See id.

Avoided cost pricing builds on this basic point. Suppose that a producer uses a single facility to provide two products, A and B. The technique starts with a competitive market price for product A. Again, that price will reflect both the incremental costs of product A and a measure of joint and common costs. To derive the expected market price of the regulated product B, the costs unique to product A are subtracted from the market price. The difference will reflect the measure of joint and common costs recovered in the market price of product A. Costs unique to product B are then added to that measure of joint and common costs. The sum will approximate the costs, and hence the expected competitive market price, of product B. See Hausman Decl. ¶¶ 3-4.

This technique does not -- as the foregoing discussion makes clear -- entail the subtraction of "apples from oranges." See Becker Decl. ¶¶ 32-33; Hausman Decl. ¶ 8; Kahn Decl. at 3-4. Nor is there any truth to the worry that the Commission subtracted two "logically independent" quantities. To the contrary, the competitive market price of product A is logically dependent on the costs unique to product A as well as the joint and common costs of the facility. Likewise, the price of product B should reflect the costs unique to product B, as well as joint and common costs. By adjusting the competitive market price of product A for net avoided costs, therefore, the Commission subtracted "apples from apples" -- costs from costs.

Avoided cost pricing thus mirrors the result that would obtain in a competitive market where a single facility is used to provide two services. The producer will earn the same margin on each of the services, just the result one would expect under competition.[11] See Becker Decl. ¶¶ 23, 27, 30. As the Commission has recognized, the price set by a competitive market is the economically efficient price. See First Report and Order, 11 FCC Rcd at 20569-70, ¶¶ 55-56;

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[11]Where the relative elasticities of demand for the two products differ, a producer in a competitive market would allocate a greater proportion of joint and common costs to the product with lower demand elasticity. See Hausman Decl. ¶ 16 & n.8. As discussed above, see supra at 10-12, this point, if anything, implies that the default rate should be higher, not lower, than the local coin rate.

Order on Recon., 11 FCC Rcd at 21264-65, ¶ 61. Avoided cost pricing is thus designed to achieve the Commission's goals of "more efficient placement of payphones, improved payphone service, and lower prices for consumers." First Report and Order, 11 FCC Rcd at 20570, ¶ 55.

B. Avoided Cost Pricing Is Fair

Section 276 of the 1996 Act provides that PSPs should be "fairly compensated" for each and every call made using their payphones. 47 U.S.C. § 276(b)(1)(A). The avoided cost price for coinless calls is a "fair" price for such calls for three reasons. First, the Commission has recognized that any price set by a free and open market is, by definition, the "fair" rate. See Notice of Proposed Rulemaking, Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996, 11 FCC Rcd 6716, 6725-26, ¶ 16 (1996). Because an avoided cost price mirrors the price that would be set in the market, that price too is "fair," within the Commission's definition.

Second, the avoided cost price ensures that "each call placed at a payphone [will] bear an equal share of joint and common costs." Second Report and Order, 13 FCC Rcd at 1796, ¶ 42. Most of the costs of a payphone -- the instrument, the installation, the line, maintenance, etc. -- are common to all types of calls. See id. All payphone users derive a similar benefit from the use of the instrument and should make a similar contribution to the costs of the placement of the instrument. This principle should apply to all users -- the local caller digging in a pocket for change, a business traveler making a credit card call using 1-800-COLLECT, or the subscriber to 1-800-FLOWERS, receiving an order from a customer calling from a payphone.

Professor Hausman explains this point as follows: in a perfectly competitive market, the price of payphone service would be equal to the marginal cost of the service. However, that